1. AUDIT OF ANNUAL FINANCIAL STATEMENTS OF BANKS

In 1999 the audits of annual financial statements in all banks were carried out by international audit companies.

In expressing their opinions about the financial statements of Medicine Bank and Siauliu Bank, the auditors drew attention to some aspects of the operations of the above banks. In the case of Medicine Bank, the auditors noted the shareholder contribution accounting in 1998 annual financial statements. In expressing an opinion on the financial statements of Siauliu Bank, the auditors noted the impact of the Bank's transactions in own shares on the shareholders' equity, the structure of assets and liabilities and concentration of deposits; in addition, they suggested that the tantiemes to the members of the bank council and the board should be deducted from the result of the Bank's operations.

Last year the international audit companies that had audited 1998 financial statements issued conditional opinions on the financial statements of four banks: the Lithuanian Savings Bank, Bank Hermis, Litimpeks Bank and Medicine Bank.

In accordance with Paragraph 2 of Article 36 of the Law of the Republic of Lithuania on Commercial Banks, audited financial statements have to be published by 1 May.

2. COMPLIANCE WITH PRUDENTIAL REQUIREMENTS

Following the international audit, Vilniaus Bank, whose capital decreased due to the investment into Bank Hermis, on 1 January 2000, did not comply to some extent with the requirement of large exposure to a single borrower (the Bank's loan to Lithuanian Telecom made up 26.59 percent of the Bank's capital, while the maximum limit set by the Bank of Lithuania is 25 percent). However, on 1 March 2000 the Bank was in compliance again. With regard to Bank Hermis, after the auditing company significantly reduced its annual result, on 1 January 2000 the Bank did not comply with capital adequacy, large exposure to a single borrower and large foreign exchange and precious metals exposure requirements.

Viewing the general situation in the banking system, it is possible to claim that the operations of the majority of banks were sufficiently prudent, which is testified by their compliance with the prudential requirements with a significant reserve: on 1 January 2000, capital adequacy of the banking system was 17.63 percent (the minimum requirement of the Bank of Lithuania is 10 percent); the liquidity ratio, whose calculation methodology was significantly tightened in 1999, was 45.35 percent (the Bank of Lithuania minimum requirement is 30 percent).

3. DEVELOPMENT OF MAIN BANKING INDICATORS

At the start of 2000, the indicators of operating domestic commercial banks[1] were as follows:
assets made up LTL 11.2 billion (increase by LTL 691 million, or 6.5 percent, in 1999);
granted loans made up LTL 5.6 billion (increase by LTL 833 million, or 18 percent);
deposits made up LTL 6.9 billion (increase by 630 million, or 10 percent),
including household deposits of nearly LTL 4 billion (increase by LTL 984 million, or 33 percent, in 1999),
including deposits in the national currency of LTL 3.7 billion (decrease by LTL 119 million, or 3 percent),
including deposits in foreign currencies of LTL 3.3 billion (increase by LTL 749 million, or 30 percent);
shareholders equity made up LTL 1.3 billion (increase by LTL 13 million, or 1 percent).

[1] The concept of the banking system and the operating domestic commercial banks encompasses all commercial banks and foreign bank branches operating during the review period.

4. LOANS

Loans have remained the main part of banking assets. The share of loans (at net value) in assets structure of Lithuanian commercial banks increased from 42 percent to 47 percent in 1999, while for several preceding years a tendency of a declining share of loans in asset structure was noticeable. Crediting has remained the main field of activity for the banks and the main source of their income.

For several years a trend of an increasing share of long–term loans in loan portfolios has been observed. During the respective periods, long–term loans had the following share in the total loan portfolio structure:
1 January 1996 – 32 percent;
1 January 1997 – 35 percent;
1 January 1998 – 41 percent;
1 January 1999 – 51 percent;
1 January 2000 – 57 percent.

The increase of long–term loans in the banking system by LTL 764 million in 1999 for the large part was determined by the increase of these loans in the merged Vilniaus Bank and Hermis Bank. These banks have attracted most long–term credit resources, first of all from foreign credit and financial institutions. The largest growth in long–term loans was recorded in loans to private companies (LTL 549 million, 32 percent) and households (LTL 161 million, 39 percent).

On the one hand, such growth of long–term loans is beneficial to the country's economy as companies get a possibility to undertake long–term projects. The largest part of loans to households was used to credit housing needs. On the other hand, such trends imply bigger risks for banks, as long–term loans are generally more risky than short–term loans because it is not only difficult to project changes in the borrowers' financial position but also the prospects of the credited business in general.

The development of loan portfolio quality in the operating banks is presented in the table below.

Development of Loan Portfolio Quality in the Operating Banks

Date	Loan provisions / granted loans, %	3, 4 and 5 category loans / total loans, %
1 January 1997	20.68	32.1
1 January 1998	18.52	28.25
1 January 1999	5.92	12.46
1 January 2000	4.47	11.92

The general quality of the loan portfolio in the banking system improved in 1999 due to the cleanup of the loan portfolio from bad loans by writing them off (without abolishing the right of claim) and moving them to non–systemic accounts (in 1999 six commercial banks wrote off and moved to non–systemic accounts LTL 126 million of bad loans). On the other hand, a decline of liquidity in domestic companies and a deterioration of their financial position that was noticeable after the Russian crisis had an impact on the loan portfolio quality. This statement is supported, among other things, by the increasing share of problem loans and specific provisions at the end of 1999.

The analysis of bank loan portfolio structure by economic activity shows that the largest part of loans went to the manufacturing industry (26.5 percent of total loans), wholesale and retail trade, automobile and motorcycle repairs, personal and household utility repairs (20 percent of the total loan portfolio).

5. CAPITAL

The Lithuanian banking system has remained well capitalised. As has been mentioned above, this is confirmed by the capital adequacy ratio which on 1 January 2000 stood at 17.63 percent, i.e. well above the minimum set by the Bank of Lithuania (10 percent) and more than twice above the minimum recommended by the Basle Committee on Banking Supervision (8 percent). Therefore, the country's banking system has a sufficient buffer to absorb possible losses that may arise in the economy due to a long–term impact of the Russian crisis and/or other risks. Thus, on 1 January 2000, domestic commercial banks had LTL 508 million of capital reserves (prior to the maintenance of the capital adequacy requirement) to absorb possible losses, while these unutilised capital reserves allowed the banks to assume additional asset risk of over LTL 5 billion. Most banks are aware of the special significance of capital to the financial stability of a bank and intend to maintain a conservative stance in this respect, which is confirmed by their strategic plans for the nearest three years. Of note is the fact that the general shareholders' meetings of the banks resolved to transfer the larger part (approximately 90 percent) of 1999 profit into bank capital.

Too large influence of the state in the domestic banking sector is still often mentioned as one of the negative aspects of the banking system. At the start of 2000, the share of bank capital controlled by the state made up 33.6 percent. The influence of the state to the business decisions in the banking sector will decline after the privatisation of two state–controlled banks, the Lithuanian Agricultural Bank and the Lithuanian Savings Bank.

6. PROFITABILITY

Unaudited data showed a net profit in the system of LTL 121.4 million. After the bank audits, the system profit was reduced by LTL 9.2 million down to LTL 112.2 million. The audits reduced the profits in Vilniaus Bank, Siauliu Bank, Bank Snoras and increased the losses in Industrial Bank, Societe Generale Vilnius Branch and Nord/LB Vilnius Branch. Compared to 1998, most banks posted larger profits in 1999.

Results of Operating Banks (profit/loss)

No.	Name of Bank	1998	1999 before audit	1999 after audit
1	Lithuanian Agricultural Bank	13.2	11.8	11.8
2	Lithuanian Savings Bank	0.5	16.6	16.6
3	Ukio Bank	5.5	5.5	5.5
4	Vilniaus Bank	59.8	78.8	74.2
5	Litimpeks Bank	0.2	–	–
6	Bank Hermis[2]	0.4	–	–
7	Siauliu Bank	2.4	2.0	1.8
8	Bank Snoras	8.0	11.0	8.2
9	Medicine Bank	0.1	1.1	1.2
10	Industrial Bank	0.8	–2.0	–2.1
	Hansabankas	–	–3.9	–3.9
	SUBTOTAL	90.9	120.9	113.2
12	Kredyt Bank SA Vilnius Branch	0.2	4.7	4.7
13	Societe Generale Vilnius Branch	–2.5	–3.9	–4.6
14	Nord/LB Vilnius Branch	–	–0.3	–1.1
	TOTAL	88.6	121.4	112.2

The income structure showed the continued growth of interest income, which increased from nearly 12 percentage points to 73 percent. Income from foreign exchange operations declined by half, down to 5 percent, which is partially explained by the introduction of the euro that decreased demand for these operations and, consequently, the income from these operations. More than one fifth of income came from services and commissions. The absolute value of this income showed a slight growth, although its share in total income slightly declined.

In the structure of expenses, the largest part of expenses in 1999 was operational expenses amounting to 38 percent of the total (one year ago they accounted for 45 percent of total expenses). Interest expenses kept on increasing from 28 percent in 1998 to 31 percent in 1999.

[2] On 31 December 1999 Bank Hermis was controlled 100 percent by Vilniaus Bank and was a subsidiary of this bank and a member of Vilniaus Bank Group. The 1999 results of Vilniaus Bank Group coincided with the results of Vilniaus Bank and made up a profit of LTL 74.2 million.

7. CONTROLLED (SUBSIDIARY) COMPANIES

Most banks have subsidiary companies. On 1 January 2000, 8 banks each had a subsidiary leasing company, 4 banks had investments in 5 subsidiary insurance companies, 3 banks had investments in 4 investment subsidiaries and 2 banks had investments in the same company dealing with the technologies of servicing payment cards.

Among bank subsidiaries, Vilniaus Bank Leasing Company is the largest according to its operations. Other subsidiary companies take a very small relative share in the group. They do not have a more pronounced influence either on the compliance with the prudential requirements by the controlling bank or the results of its operations.

Beginning with 1998, the results of the subsidiary companies are audited and the auditors express their opinion about the bank's and the group's financial statements.

8. FOREIGN CREDIT INSTITUTIONS

Alongside a significant participation of foreign investors in bank capital, the interest of foreign credit institutions in the domestic financial market and their intentions to establish subdivisions in Lithuania has continued. A subsidiary of the largest Estonian commercial bank Hansapank, Hansabankas, and a Vilnius branch of the German Norddeutsche Landesbank Girozentrale started operating last year in Lithuania. Currently there are three foreign bank branches (Polish Kredyt Bank SA Vilnius Branch, French Societe Generale Vilnius Branch and the above Norddeutsche Landesbank Girozentrale Vilnius Branch) and four representative offices (Russian commercial bank Kontakt, Polish Bank Polska Kasa Opieki, CA IB Investmentbank Aktiengesellschaft from Austria and Norddeutsche Landesbank Girozentrale). Under consideration at present is the application of MeritaNordbanken, one of the largest Scandinavian banks, to open a branch in the country. MeritaNordbanken intends to take over the assets and liabilities of Societe Generale Vilnius Branch that is leaving and in this way start operations in Lithuania. In addition, AB Vereins und Westbank has applied for permission to open a representative office that later could be reorganised into an AB Vereins und Westbank branch in Lithuania. It may be expected that the process that was probably somewhat put on hold by the Russian crisis will develop further, primarily through the privatisation of the state–controlled banks.

The operations of foreign bank branches underwent some expansion in 1999. The share of assets in the banking system managed by these institutions increased from 2.1 to 3.1 percent over 1999. The share of foreign bank branches in other market segments also increased; for example, the share of loans grew from 3.7 to 4.5 percent of the total loans in the banking system, while the deposits increased from 0.4 to 1 percent of all deposits in banks. The fastest growth in the volume of operations was recorded by Kredyt Bank SA Vilnius Branch.

9. CREDIT UNIONS

Five new credit unions were registered in 1999 (the same number as in 1998). On 1 January 2000 33 credit unions were operating with the total number of 4.3 thousand members, and another two credit unions were registered early this year.

During the year credit unions continued to expand. In 1999, their assets increased by 35.4 percent and on 1 January 2000 stood at LTL 10.2 million which made up nearly 0.1 percent of the total assets of operating banks. The assets of each of the largest credit unions (Vievio Taupa, Ukininku Viltis of Panevezys and Pakruojis Credit Union) exceeded LTL 1 million.

In 1999, deposits in credit unions increased by 34.4 percent, while their largest part (67 percent) was represented by the members' deposits.

Loans to credit union members increased by 67.1 percent and made up 56 percent of credit union assets. On 1 January 2000, 16 credit unions had specific provisions on loans (total LTL 113.2 thousand). In some credit unions, the growth of specific provisions showed a deterioration of loan portfolio quality.

Investment into Government securities remained unchanged and on 1 January 2000 stood at LTL 1.6 million, representing 15.5 percent of the total assets. 52 percent of the total Treasury bills were held by the credit union Vievio Taupa.

The share capital of all credit unions made up LTL 1.8 million. During the year it increased by 36.2 percent.

In 1999 credit unions earned LTL 107 thousand in profit, which was less by LTL 9 thousand than in 1998. The decline of profit in some credit unions was determined by increased expenses on specific provisions. 22 credit unions were profitable, while 11 suffered losses.

All credit unions complied with the prudential requirements set by the Bank of Lithuania in 1999.

In 1999, enforcement measures were applied to 2 credit unions for the violation of the Law of the Republic of Lithuania on Credit Unions and other legislation. Examination of credit unions was carried out on a periodical basis, with 18 credit unions examined in 1999.

Main directions in credit institution supervision in 1999

In performing credit institution supervision, the Bank of Lithuania follows the Core Principles of Effective Bank Supervision approved by the Basle Committee on Banking Supervision whose application was supported by the Government of the Republic of Lithuania, as well as other requirements and recommendations of the Committee.

Tightening prudential requirements and the calculation procedures was in the focus in 1999. In April the Board of the Bank of Lithuania approved new rules for the calculation of the bank liquidity ratio where liquid assets are estimated on the basis of tighter criteria. In December last year the Board approved tighter ratios of the large foreign exchange and precious metals exposure that will be applied as of 1 June 2000. Apart from tightening the ratios, banks now have to estimate the risk of operations in foreign exchange and precious metals on a daily basis and ensure compliance with the requirement. As banks have been expanding their foreign exchange trade operations during the recent years, a tighter foreign exchange risk control is necessary.

An amendment to the Law on Commercial Banks has been prepared and will be adopted this year. It will supplement prudential requirements with a large exposure ratio and will grant the Bank of Lithuania the right, if necessary, to set other additional ratios, taking into account the requirements of the Basle Committee on Banking Supervision. This is related to the fact that with the development of financial markets the variety of services provided by banks and financial instruments used is increasing. Therefore banks face new risks in their operations that have to be properly managed and controlled.

The greatest focus was on managing bank risks. The aim was to provide a comprehensive and precise evaluation of various types of bank risks and establish capital needs to cover these risks. With this purpose, in co–operation with an international audit company, a project on evaluating market risks and establishing criteria and requirements for internal market risk models in commercial banks was started.

To create conditions for the banks to come up with a comprehensive estimate of credit risks, the Loan Risk Database was reformed and its services to commercial banks were expanded. The information in the database on granted loans and borrowers was widened. An important supplement is that the database will now contain data not only about the loans granted by commercial banks and foreign bank branches but also the loans granted by controlled companies and financial leasing.

Adequate regulation of accounting in credit institutions is one of the most important conditions for effective supervision. Following the evaluation of the suggestions of credit institutions and international audit companies and taking into account the latest supplements to the International Accounting Standards, the forms of statements published by banks and the requirements to explanatory notes were amended. These amendments and supplements are aimed at providing more detailed information about the operations of banks to the public at large and interested parties.

With regard to the Year 2000 risk, the focus was on ensuring compliance of the banking sector. The first results showed that information payment systems continued to function in a normal way during the transition, which meant that the work had not been wasted.

The expansion of banking activities requires for systemic planning by defining main goals, measures for achieving them and highlighting priority areas. In this regard new requirements to drawing up Operational (Business) Plans were prepared. Taking these requirements into account, in early 1999 the banks presented operational plans for 1999 as well as strategic three–year operational plans.

To widen the range of banking operations, in July 1999 the Board of the Bank of Lithuania approved additional banking operations that could be carried out by commercial banks, namely, factoring, financial intermediation and cash management.

Amendments to the rules of the Consolidation of Financial Accounts and Consolidated Supervision were prepared and adopted last year. The amendments will allow avoiding double calculations (when several banks have investments in the same credit institution or company) and coming up with a more precise estimation of the group’s results. In addition, the new edition of the rules includes insurance companies into consolidated accounts.

In 1999 the Bank of Lithuania continued close co–operation with international audit companies, including the organisation of bilateral and trilateral meetings of the Bank of Lithuanian, commercial banks and the auditors to exchange views on improving accounting and accountability issues.

The Bank of Lithuania participates in the Group of Banking Supervisors from Central and East European Countries, including regular meetings of supervision representatives.

Also, co–operation with foreign supervisory institutions was continued. This included preparation and improvement of draft agreements on co–operation in the field of credit institution supervision with the supervisory institutions of neighbouring countries – Latvia, Estonia, Sweden, Poland and Belarus. Co–operation agreements with the Central Bank of Russia and the Finnish supervisory service have already been signed.